

## Financial Markets Commentary

### 4<sup>th</sup> Quarter 2007

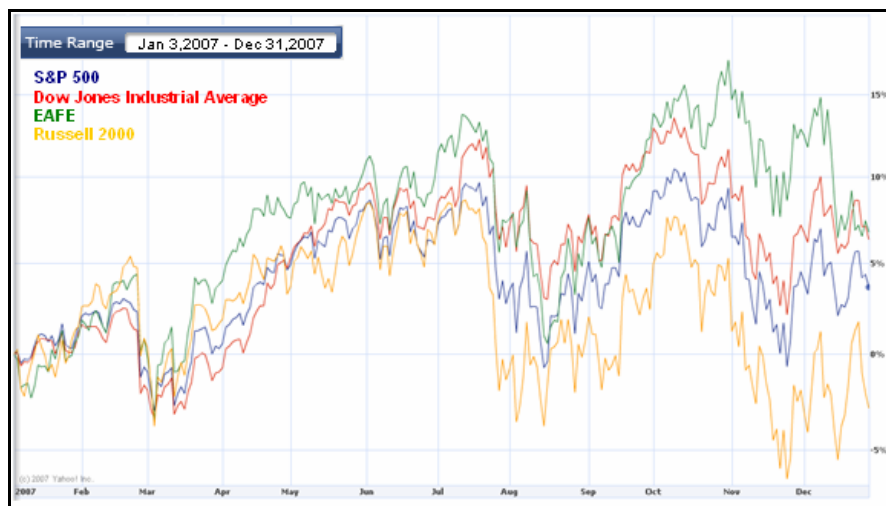
#### Summary

January 15, 2008

Stocks declined modestly during the fourth quarter of 2007. The economy has been decelerating to the point where 2008 earnings estimates have to be reduced, and that process is causing markets to be choppy. Investors have been worried about further losses from sub-prime mortgages, forcing financial services companies to take steps to re-assure nervous investors that they are still solvent. Consumer spending adjusted for inflation has been roughly flat, which has hurt companies that depend on discretionary purchases, like apparel and electronics retailers and restaurants. It is a tough investment environment right now.

The best performing sectors of the stock market were those firms able to capitalize on strength elsewhere in the world, such as energy, agriculture, and mining (except transportation stocks, which were hurt by high oil prices). Sectors that are domestic in nature, housing, casual dining & retailers performed especially poorly, except for utilities which benefited from stable demand.

For the record, the S&P 500 stock index lost -3.33% last quarter, reducing the full year gain to +5.49%. This was still much better than small stock returns, which ended a seven year streak of superior performance last year by losing -4.58% on the quarter and -1.57% for the full year. Once again, international stocks out-performed U.S. stocks. Even with a -1.75% fourth quarter loss, overseas stocks rose +11.17% for the year. Emerging markets added +3.38% last quarter, though December was a rough month.



Bonds were the big winners last quarter. When the economy weakens, interest rates tend to decline (which is good for bonds). Moreover, financial uncertainty also usually leads to increased interest in Treasury securities. The Lehman Aggregate bond index finished up +3.00% for the quarter and +6.97% for the year. With inflation concerns growing, Treasury Inflation Protected Securities (TIPS), did even better. Corporate bonds were hurt by the economic downturn, which also increases the risk of default. The Lehman High Yield bond index lost -1.30% last quarter and gained just +1.87% for the year.

## CSFC Performance

We maintained our unusually high cash position throughout the fourth quarter. This enabled us to outperform the benchmark since the stock market was lower across the board. Our Balanced Model was down -0.44% for the 4<sup>th</sup> quarter and up +7.32% for the year, the Aggressive Model was down -0.94% for the 4<sup>th</sup> quarter and up +9.46% for the year. We kept quarterly declines to less than one percent in a quarter where as all categories of stock, foreign or domestic, large or small, value or growth lost well over one percent. We did not cut back on the bond portion of the portfolio back in the Spring, so we were still able to benefit from rising bond prices. We expect to maintain this higher cash position until stock prices decline to reflect the likelihood of lower earnings in 2008.

## Outlook

Stock prices currently reflect recessionary conditions in the real estate sector, but modest growth for the economy overall. That needs to change. If the entire economy heads into recession, stock prices will certainly go lower from here. Most market strategists currently believe that we will avoid recession, but historically their track record is lousy. We suspect that with the weak employment report released on January 4<sup>th</sup> and subsequent 256 point market drop, they may ready to concede on the recession point. While government bonds have been helped by flight-to-safety buying from nervous stock investors, yields are ridiculously low right now. Alternative assets, especially those in the agriculture and precious metals sectors, are seeing a lot of interest right now. We have been using the PIMCO Commodity Real Return fund to capitalize on this.

## Commentary

As money managers for almost three decades, we have been through several full economic cycles. Last Spring the country approached the peak of an economic cycle. When everything is going right, it is always difficult to imagine how quickly things can go wrong. Investors got over-confident and were willing to pay excessive prices for the companies they wanted to own. Stock fever even gripped professional investors, who in this case formed buyout funds which offered fat premiums to take public companies private. Every cycle has its own unique high profile acquirers and targets, but the pattern is still there.

We recognized the familiar signs of speculation so we addressed them in the Commentary section of the last three quarterly Financial market Commentaries. Experience told us that we needed to begin taking profits even though we didn't know exactly when the fatal blows to this uptrend were going to come.

Back in July we wrote about inflation and slowing profit growth because these typically occur as the economy tops out. The fact is, stocks are always risky assets and unless you can buy them at prices that give you the opportunity to earn a sufficient return, you are better off investing elsewhere. When stocks trade at high prices relative to their long term earning potential, only two things can happen: stocks appreciate at a low rate while earnings catch up, or stocks decline until they offer more attractive returns.

We were aware of problems in the sub-prime mortgage area but did not imagine the level of magnitude for certain firms (Citicorp, etc.). While we were right in raising cash it was not done because of the sub-prime mortgage problems.

What matters in our view is that we observed that return expectations did not justify the risk our clients were taking in their portfolios and acted in a timely manner to avoid this. Now, having gotten defensive at the right time is fine, but if we don't get back into stock fund on a timely basis then we haven't really done you any favors. Just as we looked past the market's strength six months ago and realized that we had to get more defensive, we are now looking at the current weakness in the market for an opportunity to put our cash to work.

For example, financial stocks have taken quite a beating since mid-summer, as have homebuilders and home furnishers. More recently, all areas of retailing have been hit. The market is discounting the fact that the consumer is struggling right now, so sectors that focus on the consumer have declined to levels that offer attractive long-term returns. The problem is they could still go quite a bit lower in the short term. It is extremely difficult to buy at the bottom, so you either have to buy on the way down and hope you are close to the bottom, or buy when you feel confident that the bottom has been reached. Unfortunately, the level of certainty rises as prices rise, so by the time you know a bottom has been made, much of the opportunity may have been lost. At this point, prices are not yet low enough to justify the risk that we are buying too far ahead of the bottom, so we are still inclined to hold our extra cash in your accounts.

There also two other conditions that we are looking for in order to believe that a sector is attractive. One is liquidity, in other words, interest rates are low and credit is readily available such that businesses in that sector can flourish. The other is positive fundamentals. Put simply, is there a reason to believe that sales and profit margins in that sector can improve? For example, the problem with retail companies right now are falling sales and/or declining margins. How can we be sure that sales are not destined to go quite a bit lower before they recover? Can they improve earnings by cutting prices to increase sales, or would that kill profits by eroding margins?

**There will be a point, hopefully soon, where we will want to get more aggressive. Over the long term stocks offer the highest returns and when we believe conditions are better we will become more enthusiastic stock buyers for our clients. The market is presently in the process of discounting the reduction in profits that come with an economic slowdown. It takes a while for that process to be worked through, there will be weeks where it looks like the market is off to the races, and there will be weeks where we wonder just how bad it can get. We are committed to using our experience and expertise to capitalize on the opportunities that an economic downturn and lower stock prices inevitably will present.**

## **Capital Strategies Financial Corporation**

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